Supreme Court of the United States

No. .....

TERM A. D. 1944.

IN THE MATTER

OF

ASSOCIATED GAS AND ELECTRIC COMPANY,
Debtor,

In Proceedings for the Reorganization of a Corporation Pursuant to Chapter X of the Bankruptcy Act.

—o—

THATCHER C. JONES, FREDERICK T. SUTTON and RUSSELL M. VAN KIRK, constituting the Scrip Holders Protective Committee of ASSOCIATED GAS AND ELECTRIC COMPANY,
Petitioners and Appellants Below,

AGAINST

STANLEY CLARKE, Trustee of ASSOCIATED GAS AND ELECTRIC COMPANY, Debtor, *et al.*,
Respondents and Appellees Below.

Brief in Support of Petition for Writ of Certiorari.

BOEHM & FISCHMAN,
Attorneys for Petitioners.

LOUIS BOEHM,
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Of Counsel.

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Opinions of Courts Below.

The report and opinion of the Special Master is printed at folios 586 to 789 of the Transcript of Record.

The opinion of the District Court is printed at folios 811 to 862 of the Transcript of Record and is reported in 53 F. Supp. 107. The opinion of the Circuit Court of Appeals is printed at pages 324 to 337 of the Transcript of Record and is reported in 143 F. (2d) 640.

Jurisdiction.

1. The date of the judgment to be reviewed is July 14, 1944.

2. The statutory provision which is believed to sustain the jurisdiction of this court is subdivision (c) of Section 24 of the Bankruptcy Act as enacted June 22, 1938.

Statement of the Case.

The essential facts have been set forth in the foregoing petition. They may very briefly be epitomized.

The holders of Ageco Scrip in the principal amount of $10,199,780.03 have been classified as subordinate creditors for the purpose of excluding them from participation in the assets of the estate. The basis of the proposed exclusion is a subordination provision contained in the scrip certificates. The scrip was issued in payment of interest on the COABs. The COABs were issued in exchange for CDCs. We contend the exchange should be set aside because it was based on a fraudulent exercise of an alleged option contained in the CDCs enabling Ageco to convert the CDCs into stock at the option of the corporation. We contend that that provision was illegal. Since the CDCs were not subordinate to general creditors, the scrip, which represents interest on the CDCs should not be classified as subordinate to general creditors.

Specification of Errors.

The Circuit Court of Appeals affirmed the order classifying the scrip as subordinate to general creditors of

Ageco. The decision was upon the ground that the provision enabling Ageco to convert the CDCs into stock at Ageco's option was legal. That decision was erroneous for two reasons:

1. It ignored the statutory provisions and the public policy against a provision enabling a corporation to convert its bonds into stock at the option of the corporation.
2. It results in an inequitable windfall to other security holders of Ageco, violative of the constitutional guarantee of equal protection of laws.

ARGUMENT.

POINT I.

A provision for conversion of a corporate bond into stock at the company's option is unlawful and invalid.

There is no statutory authority for making securities convertible at the option of the issuer. The only section of the New York statutes which authorizes convertible securities is Section 16 of the Stock Corporation Law, which authorizes a stock corporation, with the consent of its stockholders, to

> "confer *on the holder* of any debt or obligation secured or unsecured the right to convert the principal thereof within such period and upon such terms and conditions as may be fixed by the resolution of the directors conferring the right of conversion, into stock of the corporation."

No authority was cited by the Circuit Court for upholding the validity of the provision for conversion into stock *at the Company's option.* In fact, the only New York

authority on the subject is an opinion of the Attorney General rendered to the Department of State on November 22, 1934, in which the Deputy Secretary of State in charge of corporations was advised that he could not accept a certificate of incorporation which gave authority to the corporation to issue bonds and debentures convertible into stock of the corporation *at the option of the corporation.*

The opinion of the Attorney General in its entirety is as follows:

"22nd November 1934

Department of State
The Capitol
Albany, N. Y.

Attention Hon. Frank S. Sharp
Deputy Secretary of State

Dear Sirs:

You have submitted to me the proposed certificate of incorporation of The Joker Corporation, presented to you for filing under the provisions of Article 2 of the Stock Corporation Law, and requested my opinion as to whether the same is entitled to be filed in view of the underscored portion of the following provision thereof:

'The Corporation to have the power to borrow money, and from time to time to make, accept, endorse, execute and issue bonds, debentures, promissory notes and other obligations of the Corporation for moneys borrowed or in payment for property acquired or for any of the other objects or purposes of the Corporation or its business, and to secure the payment of any such obliga-

tions by mortgage or pledge, or by other lien upon, or assignment of any part of the property of the Corporation, *and to provide in and by such bonds and debentures that the same shall be, at the option of the Corporation, to be exercised by a majority of the board of directors of the Corporation, convertible into stock of the Corporation under such terms as the Corporation may provide in such bonds and debentures.'*

Section 16 of the Stock Corporation Law confers upon every stock corporation other than a moneyed corporation the power to borrow money when necessary for the transaction of its business, for the exercise of its corporate rights, privileges or franchises, or for any other lawful purpose of its incorporation, and to issue and dispose of its obligations for any amount so borrowed and, with the consent of the holders of not less than two-thirds of the total number of shares outstanding entitled to vote thereon, to mortgage its property and franchises to secure the payment of any such obligations, or of any debt contracted for such purpose. The section further provides that, when authorized by like consent, the directors, under such regulations as they may adopt, may confer on the holder of any debt or obligation, secured or unsecured, the right to convert the principal thereof within such period and upon such terms and conditions as may be fixed by the resolution of the directors conferring the right of conversion, into stock of the corporation.

It will be observed that, under the statute, the option of conversion rests with the stockholder and not with the corporation, as the proposed certificate assumes to provide.

> The provisions which may be inserted in a certificate of incorporation of a stock corporation are enumerated in section 5 of the Stock Corporation Law. That section does not provide, either directly or inferentially, that a certificate may provide for the issuance of bonds or debentures convertible into stock of the corporation, at the option of the corporation. Nor do I find elsewhere evidence of a legislative intent that such a provision is permissible.
>
> You are accordingly advised that the proposed certificate is not entitled to be filed in its present form."

This opinion of the Attorney General of the State of New York is cavalierly disposed of by the Circuit Court of Appeals as the "opinion of an unnamed Deputy Attorney General—without citation—wherein there is no analysis of the background of the statute or of the possible reasons for the provisions contained in it" (143 Fed. [2d] 640, 645). This criticism of the opinion of the Attorney General is completely unfounded. The opinion of the Attorney General is short but sound. It is based on the lack of statutory authority for the issuance of a bond convertible at the company's option into stock. As will hereinafter be seen, the lack of statutory authority for such a provision renders it invalid. Moreover, as will also hereinafter be seen, an "analysis of the background of the statute" completely supports this conclusion.

In *Lisman* v. *Milwaukee, L. W. & W. Ry. Co.*, 161 Fed. 1020 (C. C. A. 7), doubt was expressed as to whether an option given to the holder of an obligation to convert it into stock is valid without statutory authority; and in *Wall* v. *Utah Copper Co.*, 70 N. J. Eq. 17, it was held that a common law right to issue bonds does not include a right to issue bonds convertible, at the holder's option, into

stock. The situation with respect to the CDC's is even stronger than in the cases just mentioned because Section 16 of the New York Stock Corporation Law provides only for a limited right of conversion, *i. e.*, a conversion by holders, not by the corporation.

It is not disputed that the right to issue a bond with a conversion feature is not found in the common law at all. If a corporation organized under the laws of the State of New York seeks to sustain such a power, it must be based on the General Corporation Law and the Stock Corporation Law of the State of New York. If one examines the various provisions of said statutes the conclusion is inevitable that a corporation does not have the right to issue a security convertible at its option. It is also very significant that there never has been a corporation other than Ageco which even attempted to issue such a type of security. The question is *sui generis*, stands alone, and has never been passed upon by this court. In the entire history of financial manipulation no other corporation ever attempted to issue this type of security. Hopson was the arch swindler to resort to this device.

The applicable sections of the Stock Corporation Law are briefly the following:

Section 11, which provides that a corporation may issue common and preferred stock.

Section 12, which provides that a corporation may issue stock of no par value.

Section 14, which provides that a corporation may issue stock to its employees.

Section 16, which provides that a corporation may borrow money.

Section 16 gives a corporation the right in borrowing money to issue bonds which, at the option of the *holder*, may be converted into stock. In that section there is no reciprocal right given to a corporation to issue a

bond which it may convert at *its own* option. Had it been the intention of the Legislature to confer on the *corporation,* as well as on the owner, the power to convert a bond into stock would it not have said so? The fact that the power was granted to the creditor but not to the debtor is most significant of the legislative intention to grant no such power to the debtor corporation.

Section 27 of the Stock Corporation Law gives a corporation the right to issue stock which may be converted at the holder's option into another class of stock. Again no reciprocal right is given to a corporation.

A corporation is merely a creature of the State. It has no vitality and no powers except such as are conferred upon it by the Legislature.

In *Aberdeen Bindery Inc.* v. *Eastern States Printing & Publishing Company,* 166 Misc. 904, 906 (App. Term), the Court stated:

> "Being a creature of law, it did not have the same rights or powers as individual persons, but only such as were expressly given or which arose by necessary implication from law. In England they had been created by the King's grant or by Act of Parliament through royal assent. In the United States corporate powers can be granted only by legislative act."

The New York General Corporation Law Section 13 specifically provides:

> "A corporation shall not possess or exercise any powers unless given by law or necessary to the powers so given."

It certainly cannot be said that it is necessary to enable a corporation to borrow money that it shall have the right *at its option* to convert the debt into stock. The very fact

that of all the many thousands of corporations in the United States which have borrowed untold billions of dollars from the public the only one that has resorted to this device was Ageco, demonstrates that such power is unnecessary to the raising of money. In fact, the reservation of such a privilege by a corporation attempting to borrow money would not only not assist it but would actually hinder the corporation from borrowing money from an intelligent investor.

The law is well settled that a limited authorization excludes a different and broader authorization (except, of course, as to purely incidental powers). See: *Central Transportation Co.* v. *Pullman Car Co.*, 139 U. S. 24, at 48; *Fletcher*, Vol. 7, *Cyclopedia Corporations*, Sec. 3648, and cases there cited; *Case* v. *Kelly*, 133 U. S. 21; *Pratt* v. *Short*, 79 N. Y. 437. It was held in *Knickerbocker Imp. Co.* v. *Assessors*, 74 N. J. L. 583, that the creation by the Legislature of a precise method by which, under certain conditions, stock may be retired and cancelled means that the corporation shall accomplish the same result in no other way. The same reasoning is applicable to Section 16 of the Stock Corporation Law, namely, that there may be a conversion of debt into stock at the option of the holder, but that there is no such option on the part of the corporation.

The Circuit Court of Appeals, nevertheless, sustained the validity of the provision enabling Ageco to convert the CDCs into stock. The Circuit Court of Appeals based its conclusion on a mistaken analysis of the history of Section 16 of the Stock Corporation Law. The Circuit Court, at page 645 of its opinion, stated:

> "The history of the statute and its precursors show that the restrictions it contains on certain forms of borrowing and of obligations were designed for the protection of the stockholders as a

whole and as a limitation on formal or more general previously existing powers."

The Circuit Court of Appeals reasoned that the statute provided only for bonds convertible at the *holder's* option into stock because the statute was designed solely for the protection of stockholders. The Circuit Court of Appeals sought to explain the absence of a provision in the statute authorizing the issuance of bonds convertible at the *company's* option into stock on the ground that such a provision is unnecessary for the protection of stockholders, but rather of creditors.

The Circuit Court of Appeals, however, was in error in believing that the statute was intended solely for the protection of stockholders. The statute was also intended to protect creditors. *In re Progressive Wallpaper Corp.*, 230 Fed. 171, (D. C., N. D., N. Y., 1916), the Court, in discussing the prior statute, at page 176 stated:

> "As an original proposition under the section of the statute referred to, it would seem plain to this court that the requirement of the consent of the stockholders *was not for the benefit or protection of the stockholders alone,* but for the protection and benefit of the corporation itself *and the benefit and protection of the creditors of the corporation.* The statute itself does not declare that it is for the protection of the one any more than for the protection of the other. It is now elementary law and well decided that the directors of a corporation hold its property in equity as a trust fund for the benefit of the creditors of such corporation and also for the benefit of the stockholders. The proceeds of such property is to be applied in equity, first to the discharge of the debts of the corporation, and the surplus, if any, goes to the stockholders. In fact, stockholders cannot take the assets of the corpora-

> tion for their own benefit to the exclusion of the creditors, and hence a provision for the benefit of the stockholders is a provision for the benefit of the creditors of such corporation. * * *
>
> "That which is for the benefit of the stockholders of a corporation is primarily for the benefit of the creditors of such corporation, inasmuch as unencumbered property owned by such corporation is in equity a trust fund in the hands of the officers and directors, for the benefit of and to be applied first to the payment of creditors, and the balance, if any, to be divided amongst the stockholders on the winding up of the corporation."

Similarly, in *Hamilton Trust Co.* v. *Clewes*, 17 App. Div. 152, aff'd 163 N. Y., 423, the Court in discussing former Section 6 of the Stock Corporation Law, from which Section 16 was derived, said at page 156, that the object of the statute was

> "to protect the corporation, its stockholders, and, in proper cases, its creditors, against the improvident and wrongful acts of the officers of the corporation."

Thus, the Circuit Court of Appeals was mistaken in its assumptoin that the statute was designed solely for the protection of stockholders and, for that reason, contained no provision for bonds convertible at the *company's* option into stock. The statute did not provide for such an option because the legislature did not intend to authorize it!

The question of the legality of an option of a corporation to convert its bonds into stock is not merely a question of New York law. It is a question affecting every corporation in the United States. The question is: Does the power of a corporation to borrow money include the power to issue a bond convertible at the option of the corporation into stock? The Circuit Court answered this

question in the affirmative (Record, p. 333). It is a question of paramount public importance, which should be answered by this Court.

As appears from page 333 of the record, the Circuit Court of Appeals referred to our plea of public policy but did not otherwise discuss or reply to it. Our argument of public policy against a provision of this type requires no extended discussion. We submit that an option of a corporation to convert its bonds into stock is a wholesale invitation to cheat the public, and could readily accomplish a fraudulent end. Its effect, for example, if exercised just prior to bankruptcy or insolvency, would be to give certain creditors a preference over others. The corporation would always exercise the option when it would be to its advantage to do so. This court should declare the public policy against such an option before the opportunity is grasped again to sell to the American public a security convertible at the company's option into stock.

POINT II.

The order appealed from results in an inequitable windfall to the other security holders of Ageco, violative of the constitutional guarantee of equal protection of laws.

The elimination of the scrip from participation in the reorganization of Ageco would result in a gross inequity. If the scrip is eliminated, a holder of a Convertible Obligation participates equally whether or not he owns the scrip which was issued in payment of interest on his Convertible Obligations. Certain of the holders of Convertible Obligations who received them in exchange for Convertible Debenture Certificates have sold or parted with their scrip. Some of them had sold their scrip to Associated Gas and Electric Company. Some of them used their scrip in payment of electric light and gas bills or the purchase of electric appliances from Associated Gas and Electric

Company. These holders of Convertible Obligations who have parted with their scrip have already benefited to the extent of the consideration received by them for their scrip. On the other hand, those holders of Convertible Obligations who still retain the scrip which was issued to them as interest on their Convertible Obligation have received no such benefit. It is inequitable to treat equally all holders of Convertible Obligations without regard to whether or not they still own the scrip which was issued to them in payment of interest. The only remedy for this obviously unfair result is to provide participation for the scrip holders. Otherwise, holders of CO's who sold their scrip will be unjustly enriched at the expense of holders of CO's who retain their scrip, which plainly violates the constitutional guarantee of equal protection of the laws.

Conclusion.

It is therefore respectfully submitted that this case is one which calls for the exercise by this Court of its supervisory powers in order that the order of affirmance of the Circuit Court of Appeals which operates to exclude many thousands of creditors from participation in the estate, may be presented to this Court for consideration and decision, and that to such end a writ of certiorari should be granted and this Court should review the decision of the Circuit Court of Appeals, and finally reverse the same.

Respectfully submitted,

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